BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Inter-exchange Carriers	CC Docket No. 00-256
Federal-State Joint Board on Universal Service	CC Docket No. 96-45
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	CC Docket No. 98-77
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	CC Docket No. 98-166

REPLY COMMENTS OF THE CALIFORNIA PUBLIC UTILITIES COMMISSION AND THE PEOPLE OF THE STATE OF CALIFORNIA

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I. INTRODUCTION AND SUMMARY

The California Public Utilities Commission and the People of the State of California (California) respectfully submit these reply comments in response to initial comments filed regarding the Notice of Proposed Rulemaking (NPRM) released January 5, 2001 by the Federal Communications Commission (FCC) in the above-captioned proceeding. In its NPRM, the FCC sought comment on a Petition for Rulemaking filed by the Multi-Association Group (MAG), a coalition of associations representing rural carriers.[1] MAG seeks the adoption of its proposal to reform access charges and universal service support for incumbent local exchange carriers (LECs) subject to rate of return regulation (rural or non-price cap carriers).

In its initial comments, California expressed concerns regarding numerous aspects of the MAG proposal that, taken together, would increase the earnings and universal service funding received by rural LECs while shielding them from risk and providing little incentive to operate more efficiently or invest wisely. California's initial comments highlighted, in particular, the failure of the MAG proposal to structure universal service support based on forward-looking costs, the unjustified recovery of access revenues through universal service funding, the improper perpetuation of the National Exchange Carrier Association (NECA) pooling system, possible restrictions on portability of universal service support, the removal of caps on universal service support, inclusion of unrelated costs in universal service funding, unjustified annual

[1] MAG consists of the National Rural Telecom Association, the National Telephone Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, and the United States Telecom Association.

increases in universal service funding, an overly-generous low end adjustment, excessive deaveraging of subscriber line charges (SLCs) and universal service support, and elimination of important merger/acquisition safeguards. California recommends that the FCC reject the MAG proposal, take steps to base universal service support to rural LECs on forward-looking cost, and eliminate the NECA pooling system. In its initial comments, California also identified various modifications that would be needed to minimize the adverse impacts of the MAG proposal if the FCC adopts some or all of it.

In these reply comments, California points out that MAG proponents have still provided no evidence to justify the additional revenues that rural carriers would receive through the MAG proposal. If the FCC is concerned about the sufficiency of current universal service funding mechanisms, California suggests a waiver process whereby a rural LEC may request additional federal universal service funding upon a clear showing of need. California recommends that, if the FCC undertakes access charge and universal service reform for rural LECs, cost-based policies already adopted for price cap LECs be implemented for rural LECs as well. In particular, the FCC should reiterate that universal service funding for rural LECs should be based on forward-looking costs, and should refer to the Joint Board the narrow issue of proper implementation of forward-looking cost-based universal service funding for rural LECs. If incentive regulation is adopted for rural LECs, California recommends that the FCC require consistent application to all rural LECs or, alternatively, to all rural LECs above a certain size. To the extent incentive regulation is based on embedded costs, three years of historical data should be used. California continues to oppose any weakening of the current merger/acquisition safeguards and cautions that, if the FCC does expand universal service funding for exchanges transferred to rural LECs, such additional funding should be limited to case-by-case showings of need, with a strict cap on such funding from federal universal service funds.

II. THE MAG PROPOSAL WOULD INCREASE RURAL LEC REVENUES AND UNIVERSAL SERVICE FUNDING WITH NO JUSTIFICATION

MAG asserts that its proposal is revenue-neutral for non-price cap carriers.[2] However, it is almost certain that the incentive regulation and universal service provisions in the MAG proposal would increase revenues compared to the revenues that rural carriers would receive under the existing interstate access and universal service mechanisms. MAG has provided no empirical evidence or other justification that rural carriers need such additional funding, that the current federal universal service mechanism for rural carriers is not sufficient, or that rural carriers' customers, as opposed to shareholders, would benefit from the increased revenues.

MAG's arguments that additional federal funding is needed to spur investment in advanced technologies are particularly spurious. MAG has produced no evidence that investment in advanced technologies is lagging in rural areas. Additionally, the MAG proposal to increase revenues in no way ensures deployment of infrastructure needed to support advanced services. As the New York Department of Public Service noted, increasing rural high cost funding would be a particularly inefficient means of promoting such investment.[3]

The proponents of expanded federal universal service funding ignore the portion of the 1996 Act that puts some of the responsibility for providing "sufficient" universal service funding on the States. They provide no discussion at all of the extent to which state mechanisms could

[2] MAG Comments at 9.

[3] Comments of the New York State Department of Public Service at 1.

be tapped to ensure that universal service funding is adequate. Instead, they take the position that the federal program should be expanded on a nationwide basis. If the FCC is concerned that the existing federal universal service mechanism, coupled with reasonable state mechanisms, may be insufficient, the FCC may wish to consider incorporating a waiver process, whereby a rural LEC may request that it receive additional federal universal service funding. Such waiver requests should be granted only upon a showing that the available federal and state funding mechanisms are not sufficient to maintain affordable universal service to the rural LEC's customers.

California recognizes the difficulties that arise in balancing the statutory requirement that universal service support be "sufficient" with the need to contain costs and thus the burden on customers elsewhere in the nation. The appropriate solution is to target support carefully based on forward-looking economic costs. Such an approach ensures that carriers receive funding sufficient to provide high quality service while providing incentives to invest wisely and efficiently and should be adopted. In contrast, the flawed MAG proposal would extend inappropriately and expand the rural carriers' expectations that their expenditures will be funded on an unlimited basis.

III. THE MAG PROPOSAL FAILS TO INCORPORATE IMPORTANT UNIVERSAL SERVICE AND ACCESS CHARGE STRUCTURAL REFORMS ALREADY ADOPTED FOR PRICE CAP CARRIERS

Commenters identified several areas in which the MAG proposal fails to incorporate access and universal service policies already adopted for price cap carriers. Absent compelling justification for deviation, California believes that any access charge and universal service reform undertaken for the rural LECs should incorporate cost-based policies already found reasonable for price cap LECs. However, California would not support automatic application to rural LECs of non-cost based reforms, e.g., negotiated aspects of the CALLS proposal.

California explained in its initial comments that universal service funding for rural carriers should be based on forward-looking economic costs, consistent with the current method of universal service funding for price cap LECs.[4] California recommends that the FCC refer the issue of the proper implementation of forward-looking cost-based universal service support to the Joint Board, with express instructions to the Joint Board that it base its subsequent recommendations on forward-looking costs.

Any access charge reform for rural carriers should incorporate cost-based structural reforms previously adopted for price cap LECs to make their access charges more cost-based. Similarly, rural LECs should be required to recover universal service contributions from their end users through a separate rate element or line item, as do price cap LECs. The Rate Averaging Support (RAS) proposed by MAG would provide universal service funding for any residual revenue requirement for Path A pooling carriers, including their universal service contributions. However, funding a rural carrier's universal service contributions through universal service support would violate Section 254(e)'s requirement that carriers use universal service support only for the facilities and services for which support is intended. Nor should rural carriers be allowed to recover their universal service contributions from IXCs, because such recovery would constitute an impermissible implicit subsidy and not be competitively neutral.

[4] California Comments at 8.

IV. MANY COMPONENTS OF THE MAG PROPOSAL ARE SERIOUSLY FLAWED

A. Incentive Regulation for Rural LECs

The MAG proposal would allow each rural carrier to retain rate of return regulation (Path B) or to phase in a form of incentive regulation (Path A) for each study area over a five-year period. In its initial comments, California opined that the vast majority of rural LECs will find Path A attractive, since it appears to be a very profitable opportunity for most carriers.[5]

Some commenters take issue with the MAG provisions that would allow rural LECs to choose between the two forms of regulation, and to determine when, during a five-year period, to transition each study area to incentive regulation.[6] Concerns were also raised regarding rural carriers' ability to manipulate investments and the timing of incentive regulation in order to increase the Revenue Per Line (RPL) baseline[7] and their ability to control whether and when to make explicit universal service support available to competitive Eligible Telecommunications Carriers (ETCs).[8] On the other hand, MAG proponents argue that the two-path approach recognizes the extreme diversity that exists among rural LECs[9] and that the five-year transition period is needed to accommodate the "lumpy" investment patterns of rural LECs.[10]

Like other aspects of the MAG proposal, rural LECs' ability to choose between Path A

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[5] Id., at 11-12.

[6] See, Competitive Universal Service Coalition Comments at 5 and 10 and AT&T Comments at 13.

[7] See, Florida Public Service Commission Comments at 6, AT&T Comments at 13, and WorldCom Comments at 4.

[8] Competitive Universal Service Coalition Comments at 5 and 10.

[9] See, MAG Comments at 5; Small Rural LEC Comments at 4.

[10] MAG Comments at 22.

and Path B, with a five-year transition period, creates an inappropriate win-win opportunity for the rural LECs at the expense of customers elsewhere in the country who must fund this overly generous offering. The vast majority of rural LECs would likely find Path A attractive, and it can be expected that they would time their move to incentive regulation to increase and maximize their revenue far above levels that are needed or will be used to maintain quality service. The main accommodation of such carriers' "lumpy" investment patterns is that a carrier is allowed to choose a year with relatively high investment, and indeed plan ahead to increase investment in that year, and then use that year as the basis for all future years' RPL calculations. Such overly favorable accommodation comes at the expense of customers. Without a requirement that the additional funding be invested in the network, these very favorable provisions of the MAG proposal would provide windfall opportunities for the rural LECs' owners.

California believes that the MAG proposal should be rejected in its entirety. However, if the FCC chooses to adopt a form of incentive regulation for rural LECs at this time, several important modifications should be made to mitigate some of the worst aspects of the MAG proposal. First, the ability of rural LECs to choose whether and when to commence incentive regulation should be eliminated. The FCC should require that all rural LECs or, alternatively, all rural LECs above a certain size, be subject to incentive regulation, which would commence at the same time for all study areas of a rural LEC. Additionally, to the extent incentive regulation is based on embedded costs, the FCC should require that three years of historical cost data, e.g., costs incurred during the years 1998 through 2000, be used in order to avoid manipulation of the cost data.

B. Access Charge Reform

The MAG proposal provides that the Composite Average Rate (CAR) for pooling Path A LECs would be phased down to $0.016 per minute by July 1, 2003. In initial comments, California expressed concern about the provision for automatic recovery of the access reductions through the SLC and the RAS.[11]

The Competitive Universal Service Coalition takes issue with the MAG provision that only Path A pooling LECs would be required to reduce their traffic-sensitive access rates.[12] AT&T recommends that the CAR be reduced to $0.0095 per minute, consistent with the access charges of CALLS' "primarily rural" price cap LECs.[13]

While California supports cost-based pricing of access charges,[14] California reiterates its opposition to automatically recovering above-cost access revenues through universal service funding. As California has explained, above-cost access charges may include many items, including the misallocation of non-access costs, recovery of embedded access costs in excess of forward-looking costs, excess contribution to shared and common costs, and/or excess profits, in addition to the alleged subsidization of below-cost basic services.[15] Before moving any portion of access revenues to universal service funds, the FCC should require that the components of those revenues be identified, with universal service funding allowed for only the portion that

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[11] California Comments at 14.

[12] Competitive Universal Service Coalition Comments at 3 and 10.

[13] AT&T Comments at 6.

[14] Reply Comments of the People of the State of California and the Public Utilities Commission of the State of California on the Notice of Proposed Rulemaking, CC Docket 92-262 et al., February 13, 1997, at 7.

[15] California Comments at 8-9.

subsidizes services targeted for universal service support. Unless and until such an analysis is undertaken, California cannot support AT&T's proposal to reduce the CAR even further. If the FCC determines that rural carriers' access charges should be reduced, California agrees with the Competitive Universal Service Coalition that the reductions should be implemented for all rural carriers, not just Path A pooling LECs.

C. Universal Service Support

1. Rate Averaging Support

Rate Averaging Support (RAS) funding would be available to pooling Path A LECs, including a common line component consisting of the difference between pooled common line revenue requirements and the participants' SLC, CCLC, and Long Term Support; a traffic-sensitive component consisting of the difference between pooled traffic-sensitive switched revenue requirements and the participants' CAR rates and Local Switching Support; and a special access component consisting of the difference between pooled special access revenue requirements and the participants' special access revenues. After June 30, 2006, NECA adjustments to bring Path A settlements and revenues into balance would also be included in the RAS.

MAG contends that the existence of RAS funding and the resulting lower per-minute access rates will motivate carriers to move to Path A and incentive regulation and that this is appropriate because Path A provides correct economic signals and increases opportunities for efficient competitive entry.[16] MAG asserts further that special access services are highly competitive and that RAS funding is needed to ensure that competition is not stifled by the

[16] MAG Comments at 17-18.

inability of affected companies to compete in high-cost areas.[17] AT&T counters that RAS funding should be available to all rural carriers, to fund access reductions that AT&T would apply to all rural carriers.[18]

California has already explained its opposition to MAG's basic concept that universal service funding should be employed through the RAS to recover switched and special access revenue requirements and to bring Path A LECs' settlements and revenues into balance.[19] Further, subsidization of rural carriers' special access services would stifle rather than promote competition as MAG claims. Additionally, while California supports moving common line revenue requirement to non-traffic sensitive charges such as the SLC,[20] California sees no basis for recovering any remaining residual common line revenues through universal service funding.

If the FCC decides to allow RAS funding, it should not be limited to Path A pooling LECs. In its attempt to benefit all rural carriers, the MAG proposal is unnecessarily complex. Carriers should not be given the option to choose between incentive and rate of return regulation, and the NECA pool should be eliminated, as California has explained. Further, any rural carrier access reductions should be implemented equally for all rural carriers. With these changes, there would be no basis for limiting the availability of any RAS funding that may be approved.

As California has explained,[21] if RAS funding is allowed, the FCC should cap such

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[17] Id., at 20.

[18] AT&T Comments at 10.

[19] California Comments at 17-18.

[20] Comments of the People of the State of California and the Public Utilities Commission of the State of California on the Notice of Proposed Rulemaking, CC Docket 92-262 et al., January 30, 1997, at 1-2.

[21] California Comments at 18.

funding based on a reasonable estimate of the gap between rural LECs' forward-looking cost of providing basic service and the revenues, including the SLC, basic line rates, and current universal service funding, that are received for the purpose of funding basic service. AT&T's proposal to shift most switched access revenues to universal service funding would inappropriately burden customers in contributing states by requiring them to support services and costs not targeted for universal service support.

2. Deaveraging Universal Service Support

The MAG proposal allows universal service support to be deaveraged in up to three geographic areas per wire center, with no cost support. In its initial comments, California recommended that rural carriers be allowed to disaggregate universal service support only on the basis of demonstrable cost differences and only to the extent that unbundled network element (UNE) rates are deaveraged.[22] Incumbent rural carriers should not be allowed to disaggregate universal service support unilaterally without regulatory approval and oversight. While MAG contends that its proposal creates regulatory certainty,[23] in reality allowing an incumbent LEC to unilaterally modify the per-line universal service support would create enormous uncertainty that could be devastating to a competitive ETC that has made a business decision to enter an area based on a particular level of support, and could deter other carriers from even trying to compete with the incumbents.

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[22] Id., at 19.

[23] MAG Comments at 6.

D. Revenue and Universal Service Indexing Factor for Incentive Regulation

Once subject to incentive regulation, Path A LECs' interstate revenue requirements would be indexed by inflation and the growth in access lines. Several commenters [24] share California's view that any indexing factor used for interstate revenues and/or universal service funding should be reduced by a productivity factor.[25] AT&T asserts that rural carriers' costs have not increased in proportion to inflation and access line growth, and indeed that application since 1995 of the MAG growth factors would have resulted in a $424 million divergence from the rural carriers' actual costs in 1999.[26] MAG argues that it is infeasible to develop a productivity adjustment that reflects the productivity of non-price cap LECs compared to the rest of the economy, since non-price cap LECs serve only about 7 percent of access lines. It asserts that application of a productivity factor would mean that only those carriers with the least costs or the strongest line growth would even consider Path A incentive regulation.[27]

MAG's omission of any productivity adjustment has the effect of assuming that rural LECs do not achieve any productivity growth beyond that realized by the economy as a whole. However, that assumption runs counter to the widespread and on-going reductions in telecommunications costs. AT&T's analysis of NECA data, if accurate, would support the view that a productivity adjustment is appropriate for rural carriers. MAG's approach, on the other hand, would make rural LECs' revenues so high that even the highest cost rural LECs would

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[24] See, Ad Hoc Telecommunications Users Committee Comments at 16, and AT&T Comments at 16.

[25] California Comments at 22-23.

[26] AT&T Comments at 16 and Appendix A.

[27] MAG Comments at 24.

benefit from incentive regulation without the need to become more efficient. And lower cost rural LECs would reap an unjustified windfall. California reiterates its view that the FCC should initiate a further notice of proposed rulemaking to establish a productivity factor and address other related issues if it wishes to adopt incentive regulation for rural carriers.

E. Mergers and Acquisitions

The MAG proposal would eliminate several existing safeguards that currently limit the ability of carriers to transfer exchanges in a manner that would game the universal service and price cap systems. MAG would eliminate the all or nothing rule which requires that a price cap LEC must shift new affiliates to price cap regulation, the freeze on study area boundaries, and the Section 54.305 provision that an acquiring LEC receive universal service support at the same per-line rate as the prior owner. Additionally, MAG would provide that revenues and universal service funding for acquired exchanges would be based for 18 months on the average revenue per line and average per-line universal service receipts of all pooling Path A LECs, thus allowing pooling rural LECs that purchase relatively low cost exchanges to reap an 18 month windfall. In its initial comments, California opposed all of these changes.[28]

MAG asserts that accounting safeguards and reporting requirements eliminate any concerns about cost shifting that led to the all or nothing rule, that the freeze on study area boundaries does little except require a LEC to seek a waiver and incur delays and unnecessary costs, and that Section 54.305 discourages non-price cap LECs from acquiring and upgrading inferior plant.[29] The Independent Telephone and Telecommunications Alliance asserts that its

[28] California Comments at 25-26.

[29] MAG Comments at 28-29.

members often must invest heavily in newly acquired exchanges to upgrade neglected facilities and launch new services.[30]

California continues to oppose elimination of the all or nothing rule. Despite MAG's assurances, the relaxed accounting and reporting requirements for rural LECs would make it extremely difficult to detect cost shifting among price cap and non-price cap properties. Additionally, elimination of the all or nothing rule would deprive customers in exchanges acquired by a price cap carrier of the benefits of economies of scale and other efficiency gains achievable by the price cap carrier. As WorldCom notes,[31] elimination of the all or nothing rule would allow Puerto Rico Telephone Company (PRTC) to remain under rate-of-return regulation. However, if that is allowed to occur, the benefits of price cap regulation that the FCC cited in approving the PRTC/GTE merger would be lost and the universal service fund would continue to be burdened unnecessarily.

Nor is California convinced that additional universal service funding should be offered, through the elimination of Section 54.305, as an enticement needed to provide quality service in high cost exchanges. One outcome of determining federal universal service support on the basis of costs measured at the study area level (which California supports[32]) is that some multi-exchange carriers with some low cost exchanges may not receive universal service support for their high cost exchanges. However, such carriers should not be allowed to neglect the high cost exchanges. The FCC and the state commissions should hold such a carrier to an expectation that

[30] Independent Telephone and Telecommunications Alliance Comments at 1.

[31] WorldCom Comments at 6.

[32] Comments of the People of the State of California and the California Public Utilities Commission, CC Docket No. 96-45 et al., July 22, 1999, at 10-12.

it will provide quality service in all of its exchanges, regardless of cost variations. The states can also assess whether additional state universal service funding is warranted in such circumstances.

Supporters of the elimination of Section 54.305 may believe that universal service funding available to non-rural carriers is not sufficient to support the investment needed to maintain quality service. However, they have introduced no evidence to that effect. Even if such evidence were forthcoming, the proper solution would be to correct any non-rural carrier funding deficiencies rather than to adopt the flawed MAG approach. There is no reason to believe that rural carriers can serve high cost exchanges at lower cost than can non-rural carriers. To the contrary, non-rural carriers can achieve cost savings due to economies of scale that may not be available to rural carriers.

As an additional concern, the transfer of exchanges to non-rural carriers could stifle competition in those exchanges. The 1996 Act provides protection for rural exchanges; for example, competitive carriers must make a "public interest" showing in order for the rural exemption to be lifted and for rural carriers to be required to open up their networks to competition. The sale of exchanges to rural carriers would expand those rural carrier protections to more and more exchanges. Indeed, such transfers call into question the treatment of competitive carriers that have already applied for or received ETC designation for exchanges that are subsequently sold to a rural carrier.

If the FCC chooses to modify or eliminate Section 54.305 to expand funding for exchanges transferred to rural carriers, it should put a strict cap on the amount of money that would be available for such purposes and should require that such funding be granted only on a case-by-case basis upon a demonstration that additional funding is necessary to provide quality basic service to customers in the acquired exchange(s). In comments regarding the Rural Task

Force's pending proposal, the Maine and Vermont Commissions reported that 80 percent of customers in high cost exchanges are served by non-rural carriers.[33] Without safeguards, elimination of Section 54.305 could unleash a wholesale transfer of a substantial portion of those high cost exchanges to rural carriers, in order to receive the benefits of their more lucrative universal service funding. This concern is heightened in light of other MAG components that would tend to increase the level of rural carrier revenues. The combination of non-cost based revenue enhancements for exchanges owned by rural companies and the ability to obtain such favorable treatment for exchanges acquired by such companies would increase the value of rural exchanges owned by price cap LECs and, thus, would allow them to sell these exchanges at a higher price.

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[33] Comments of Maine and Vermont Commissions, CC Docket 96-25 et al., February 26, 2001, at 4.

V. CONCLUSION

California recommends that the FCC reject the MAG proposal and initiate steps to base rural universal service support on forward looking cost, for reasons and as discussed in California's initial comments and in these reply comments.

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